

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ALTERNATIVE RATE ADJUSTMENT FILING OF) CASE NO. 2011-00425
MILBURN WATER DISTRICT)

NOTICE OF FILLING OF COMMISSION STAFF REPORT

Pursuant to the Commission's Order of November 7, 2011, Commission Staff files the attached report containing its findings and recommendations regarding Milburn Water District's proposed rate adjustment.



Jeff Derquen
Executive Director
Public Service Commission
P.O. Box 615
Frankfort, KY 40602

DATED: FEB 01 2012

cc: Parties of Record

STAFF REPORT
ON
MILBURN WATER DISTRICT
CASE NO. 2011-00425

On October 26, 2011, Milburn Water District ("Milburn") filed with the Commission an application to adjust its current rates for water service. Using its historical operations for the calendar year ending December 31, 2010 and adjusting for known and measureable changes, Milburn proposes rates that will reportedly produce additional revenues from water sales of \$10,915, an increase of 19.96 percent over pro forma revenues from water sales. For a customer who purchases 5,000 gallons of water monthly, his monthly bill will increase from \$33.92 to \$40.73, or approximately 20 percent.

Sam Bryant and Eddie Beavers of the Commission's Division of Financial Analysis performed a limited financial review of Milburn's test-year operations to determine whether test-period operating revenues and expenses are representative of normal operations and the proposed adjustments are reasonable. They did not pursue, nor have they addressed in this report, insignificant or immaterial discrepancies. Where they have not expressly addressed a test-period expense, they found insufficient evidence to contest the reasonableness of that expense.

This report summarizes Commission Staff's review and recommendations. Mr. Beavers reviewed Milburn's pro forma revenue adjustment and its calculation of the recommended rates. Mr. Bryant addresses all pro forma expense adjustments and the revenue requirement determination. Milburn's pro forma operating income statement is

set forth in Appendix A. In Appendix B, Commission Staff explains each of its proposed pro forma adjustments.

The Commission has historically used the Debt Service Coverage (“DSC”) methodology to determine the revenue requirement for water districts. This approach is used primarily because a bond ordinance or loan agreement requires the water district or association to maintain a predetermined DSC level. Commission Staff, however, does not recommend the use of this methodology in this case because Milburn has no outstanding long-term debt.

Commission Staff instead recommends that the operating ratio methodology be used to calculate Milburn’s revenue requirement.¹ This approach is used when there is no basis for a rate-of-return determination, the cost of the utility has fully or largely been funded through contributions, or there is little or no outstanding long-term debt. Commission Staff is of the opinion that an operating ratio of 88 percent will allow Milburn sufficient revenues to cover its reasonable operating expenses, and provide for reasonable equity growth. As shown in Table 1, applying an 88 percent operating ratio to requested pro forma operations produces a revenue requirement from rates of \$68,480, an increase of \$12,025, or 23 percent above the normalized revenue from rates of \$52,360.

¹ Operating Ratio is the ratio of expenses, including depreciation and taxes, to gross revenues. It is illustrated by the following equation:

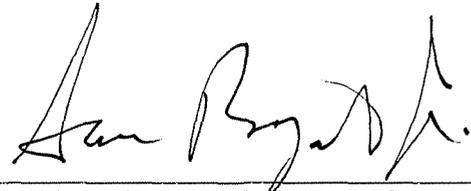
$$\text{Operating Ratio} = \frac{\text{Operating Expenses} + \text{Depreciation} + \text{Taxes}}{\text{Gross Revenues}}$$

| Table I: Revenue Requirement Determination | | |
|---|-----------|---------------|
| Net Pro Forma Operating Expenses | \$ | 60,263 |
| Divided by: Operating Ratio | ÷ | 88% |
| Subtotal | \$ | 68,480 |
| Add: Interest Expense | + | 0 |
| Total Revenue Requirement | \$ | 68,480 |
| Less: Other Income & Deductions | - | 0 |
| Revenue Requirement from Operations | \$ | 68,480 |
| Less: Other Operating Revenues | - | 4,085 |
| Revenue Requirement - Water Sales | \$ | 64,395 |
| Less: Pro Forma Revenue - Water Sales | - | 52,370 |
| Permitted Increase | \$ | 12,025 |
| Percentage Increase | | 23.00% |

Commission Staff performed a billing analysis of Milburn's test-period sales. The results of this analysis are set forth in Appendix C. Commission Staff found that, based upon test-period sales in this analysis, Milburn's proposed rates, which are found at Appendix D, will produce revenues of \$62,876. The rates set forth in Appendix E will generate annual revenues from water sales of \$68,480. Neither Milburn nor Commission Staff performed a cost-of-service study in this case. The increased revenue requirement has been uniformly allocated to each rate block.

Commission Staff recommends approval of Milburn's proposed rates. As shown in Appendix F, these rates will produce a positive net cash flow, will allow Milburn sufficient revenues to cover its reasonable operating expenses, and will provide for equity growth.

Signatures



Prepared by: Samuel J. Bryant, Jr.
Financial Analyst, Water and Sewer
Revenue Requirements Branch
Division of Financial Analysis



Prepared by: Eddie Beavers
Rate Analyst, Communications, Water
and Sewer Rate Design Branch
Division of Financial Analysis

APPENDIX A
STAFF REPORT, CASE NO. 2011-00425
PRO FORMA OPERATIONS

| | 2010 <u>Operations</u> | Pro Forma <u>Adjustments</u> | <u>Adj</u> | Pro Forma <u>Operations</u> |
|------------------------|---------------------------|---------------------------------|------------|--------------------------------|
| Water Sales | \$56,360 | \$ (4,000) | (a) | \$52,360 |
| Other Water Revenue | <u>2,302</u> | <u>1,783</u> | (b) | <u>4,085</u> |
| Operating Revenues | <u>\$58,662</u> | <u>\$(2,217)</u> | | <u>\$56,445</u> |
| | | | | |
| Purchased Water | \$19,102 | \$(1,118) | (c) | 17,984 |
| Purchased Power | 1,524 | | (d) | 1,524 |
| Materials and Supplies | 7,541 | (2,067) | (e) | 5,474 |
| Contract Services | 20,734 | 700 | (f) | 21,434 |
| Water Testing | 420 | 0 | | 420 |
| Transportation Expense | 540 | 0 | | 540 |
| Insurance Expense | 1,528 | 0 | | 1,528 |
| Miscellaneous Expense | <u>1,369</u> | <u>0</u> | | <u>1,369</u> |
| Total O & M Expenses | \$52,758 | \$(2,485) | | \$50,273 |
| Depreciation Expense | 8,647 | 0 | | 8,647 |
| Amortization Expense | 0 | 1,256 | (g) | 1,256 |
| Taxes Other Than Inc. | <u>1,612</u> | <u>(1,525)</u> | (h) | <u>87</u> |
| Total Operating Exp. | <u>\$63,017</u> | <u>\$(2,754)</u> | | <u>\$60,263</u> |
| Net Operating Income | <u>\$ (4,355)</u> | <u>\$ 537</u> | | <u>\$ (3,818)</u> |

APPENDIX B
STAFF REPORT, CASE NO. 2011-00425
EXPLANATION OF ADJUSTMENTS

(a) Revenue from Water Sales: Commission Staff reduced total revenue from water sales reported for test period to remove non-water sales revenue and adjust for the results of the billing analysis.

| | |
|---------------------------------|-----------------|
| Late Fees | \$ 1,783 |
| City Taxes | 1,575 |
| State Taxes | <u>85</u> |
| Total Non-Water Sales | \$ 3,443 |
| | |
| Total Reported Water Sales | \$56,360 |
| Less: Total Billing Adjustments | <u>3,443</u> |
| | \$52,927 |
| Billing Analysis Results | <u>\$52,370</u> |
| Billing Analysis Adjustment | \$ 557 |
| | |
| Total Non-Water Sales | \$ 3,433 |
| Billing Analysis Adjustment | <u>\$ 557</u> |
| Total Adjustment | <u>\$ 4,000</u> |

(b) Other Water Revenue: Commission Staff adjusted Reported Other Water Revenue to reflect Late Fees of \$1,783 that Milburn had erroneously included in Revenue from Water Sales.

(c) Purchased Water Expense: Test-period Purchased Water Expense was \$19,102. Milburn normalized its test-period purchases and applied the current purchased water rate to determine its normalized Test-Period Purchased Water Expense. (Normalized purchases of 8,287,428 gallons x \$2.17 per thousand gallons = \$17,984). In its 2010 Annual Report, Milburn reported 8,252,000 gallons of water purchased and 7,181,000 gallons sold. Using reported purchased and sold amounts, 12.98 percent of Milburn's purchases represented nonrevenue water. $((8,252,000 - 7,181,000) \div 7,181,000 = .1298)$. As Milburn's non-revenue water level did not exceed 15 percent, 807 KAR 5:066, Section 6(3) does not require any disallowance for unreasonable levels of non-revenue water.

(d) Purchased Power Expense: Milburn reported Purchased Power expenses of \$1,524 for the test period. In March 2011, Milburn purchased a building next to its District office. It asserts that electric bills after the purchase have increased 41 percent. It proposes to increase this expense by 41 percent, or \$625, to reflect increased purchased power expense. The alleged increase incurred outside the test period and is not supported by invoices or other documentary evidence. In the absence of such evidence, Commission Staff recommends that the proposed adjustment be denied.

(e) Materials and Supplies Expense: Milburn has reduced test-period expense of \$7,541 to remove two nonrecurring items. A drill that cost \$717.27 and inventory items that cost \$1,350 were removed and amortized over a three-year period.

(f) Contract Services: Milburn recorded \$20,734 for contract services during the test period. This amount includes: \$1,800 in Commissioners' salaries (3 commissioners x \$50 per month x 12 months = \$1,800), \$5,700 Operator fee, \$7,150 for a bookkeeper, and \$6,084 for maintenance and repair. Milburn's commissioners performed most of the maintenance and repair work. In addition, Commissioner Glynn Goldsmith serves as system operator and is paid \$475 per month. Commissioners Goldsmith, Mark Vaden, and Jeff Crider performed maintenance and repair work during the test year for which Milburn paid a total of \$5,120. While the level of these expenses appears reasonable and is documented with work orders and receipts, the payment of such compensation is inconsistent with existing law. The Attorney General has opined that such payments are improper. See OAG 66-788 ("[T]here is no statute prohibiting commissioners of a water district from contracting with the district; however, we believe that such would create a conflict of interest and be against public policy."). Accordingly, Commission Staff recommends that Milburn cease such contracts with its commissioners or, in the alternative, that the Commission consider whether removal proceedings are appropriate if the transactions continue.

Milburn proposes to adjust contract services expense by \$700 to reflect an increase in the monthly fee for bookkeeping and office management services from \$500 to \$600. Milburn reports that this expense, when coupled with its annual report preparation fee of \$650, should total \$7,800 annually. Commission Staff recommends that the proposed adjustment be accepted and that a normalized test period expense of \$7,850 for bookkeeping and office management services and a total normalized test period contract services expense of \$21,434 be used to calculate Milburn's revenue requirement.

(g) Amortization Expense: Milburn proposed to adjust this expense by \$1,256 to include amortization of \$567 over three years for rate case consulting expense of \$1,700, and to include \$689 over three years for the drill and certain inventory items which costs were removed from test-period Materials and Supplies Expense. See Adjustment (e).

(h) Taxes other than Income: Milburn proposed to reduce this expense by \$1,525 to eliminate school tax collections remitted to taxing authorities. Commission Staff concurs with the proposed adjustment.

APPENDIX C
 STAFF REPORT, CASE NO. 2011-00425
 BILLING ANALYSIS – MILBURN WATER DISTRICT'S CURRENT RATES

| Meter Size: | | 5/8 inch | | | | | | | | | |
|-------------|--------------|--------------|----------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|
| | <u>USAGE</u> | <u>BILLS</u> | <u>GALLONS</u> | <u>FIRST</u> | <u>NEXT</u> | <u>NEXT</u> | <u>NEXT</u> | <u>NEXT</u> | <u>NEXT</u> | <u>OVER</u> | <u>TOTAL</u> |
| FIRST | 2,000 | 540 | 468,040 | 2,000 | 3,000 | 3,000 | 5,000 | 10,000 | 20,000 | 20,000 | 468,040 |
| NEXT | 3,000 | 715 | 2,471,870 | 1,430,000 | 1,041,870 | 1,257,000 | 801,390 | 425,000 | 40,000 | 166,550 | 2,471,870 |
| NEXT | 5,000 | 419 | 2,896,390 | 838,000 | 1,257,000 | 801,390 | 425,000 | 198,870 | 80,000 | 166,550 | 2,896,390 |
| NEXT | 10,000 | 85 | 1,048,870 | 170,000 | 255,000 | 425,000 | 198,870 | 80,000 | 166,550 | 326,550 | 1,048,870 |
| OVER | 20,000 | 8 | 326,550 | 16,000 | 24,000 | 40,000 | 80,000 | 166,550 | 166,550 | 326,550 | 326,550 |
| TOTAL | | 1767 | 7,211,720 | 2,922,040 | 2,577,870 | 1,266,390 | 278,870 | 278,870 | 166,550 | 7,211,720 | 7,211,720 |

REVENUE BY RATE INCREMENT

| | <u>BILLS</u> | <u>GALLONS</u> | <u>RATE</u> | <u>REVENUE</u> |
|-------|--------------|----------------|-------------|----------------|
| FIRST | 2,000 | 2,922,040 | \$15.11 | \$26,699.37 |
| NEXT | 3,000 | 2,577,870 | 6.27 | 16,163.24 |
| NEXT | 5,000 | 1,266,390 | 5.74 | 7,269.08 |
| NEXT | 10,000 | 278,870 | 5.20 | 1,450.12 |
| OVER | 20,000 | 166,550 | 4.73 | 787.78 |
| TOTAL | 0 | 0 | 0.00 | 0.00 |
| TOTAL | 1767 | 7,211,720 | | \$52,369.59 |

Meter
Size: 5/8 inch

| | <u>USAGE</u> | <u>BILLS</u> | <u>GALLONS</u> | <u>FIRST</u> | <u>NEXT</u> | <u>NEXT</u> | <u>NEXT</u> | <u>NEXT</u> | <u>OVER</u> | <u>TOTAL</u> |
|-------|--------------|--------------|----------------|--------------|-------------|-------------|-------------|-------------|-------------|--------------|
| FIRST | 2,000 | 540 | 468,040 | 2,000 | 3,000 | 5,000 | 10,000 | 20,000 | 20000 | 468,040 |
| NEXT | 3,000 | 715 | 2,471,870 | 1,430,000 | 1,041,870 | 1,257,000 | 255,000 | 24,000 | 166,550 | 2,471,870 |
| NEXT | 5,000 | 419 | 2,896,390 | 838,000 | 801,390 | 425,000 | 198,870 | 80,000 | 166,550 | 2,896,390 |
| NEXT | 10,000 | 85 | 1,048,870 | 170,000 | 425,000 | 198,870 | 80,000 | 166,550 | 166,550 | 1,048,870 |
| OVER | 20,000 | 8 | 326,550 | 16,000 | 40,000 | 80,000 | 166,550 | 166,550 | 166,550 | 326,550 |
| TOTAL | | 1767 | 7,211,720 | 2,922,040 | 1,266,390 | 278,870 | 278,870 | 166,550 | 166,550 | 7,211,720 |

REVENUE BY RATE INCREMENT

| | <u>BILLS</u> | <u>GALLONS</u> | <u>RATE</u> | <u>REVENUE</u> |
|-------|--------------|----------------|-------------|----------------|
| FIRST | 2,000 | 2,922,040 | \$18.14 | \$32,053.38 |
| NEXT | 3,000 | 2,577,870 | 7.53 | 19,411.36 |
| NEXT | 5,000 | 1,266,390 | 6.89 | 8,725.43 |
| NEXT | 10,000 | 278,870 | 6.24 | 1,740.15 |
| OVER | 20,000 | 166,550 | 5.68 | 946.00 |
| | 0 | 0 | | 0.00 |
| TOTAL | 1767 | 7,211,720 | | \$62,876.32 |

Meter
Size: 5/8 inch

| | <u>USAGE</u> | <u>BILLS</u> | <u>GALLONS</u> | <u>FIRST</u> | <u>NEXT</u> | <u>NEXT</u> | <u>NEXT</u> | <u>OVER</u> | <u>TOTAL</u> |
|-------|--------------|--------------|----------------|--------------|-------------|-------------|-------------|-------------|--------------|
| FIRST | 2,000 | 540 | 468,040 | 2,000 | 3,000 | 5,000 | 10,000 | 20,000 | 468,040 |
| NEXT | 3,000 | 715 | 2,471,870 | 1,430,000 | 1,041,870 | 801,390 | 198,870 | 166,550 | 2,471,870 |
| NEXT | 5,000 | 419 | 2,896,390 | 838,000 | 1,257,000 | 425,000 | 80,000 | 166,550 | 2,896,390 |
| NEXT | 10,000 | 85 | 1,048,870 | 170,000 | 255,000 | 40,000 | 278,870 | 166,550 | 1,048,870 |
| OVER | 20,000 | 8 | 326,550 | 16,000 | 24,000 | 1,266,390 | 278,870 | 166,550 | 326,550 |
| TOTAL | | 1767 | 7,211,720 | 2,922,040 | 2,577,870 | 1,266,390 | 278,870 | 166,550 | 7,211,720 |

REVENUE BY RATE INCREMENT

| | <u>BILLS</u> | <u>GALLONS</u> | <u>RATE</u> | <u>REVENUE</u> |
|-------|--------------|----------------|-------------|----------------|
| FIRST | 2,000 | 2,922,040 | \$18.59 | \$32,848.53 |
| NEXT | 3,000 | 2,577,870 | 7.71 | 19,875.38 |
| NEXT | 5,000 | 1,266,390 | 7.06 | 8,940.71 |
| NEXT | 10,000 | 278,870 | 6.40 | 1,784.77 |
| OVER | 20,000 | 166,550 | 5.82 | 969.32 |
| | 0 | 0 | | 0.00 |
| TOTAL | 1767 | 7,211,720 | | \$64,418.71 |

APPENDIX D
STAFF REPORT, CASE NO. 2011-00425
MILBURN WATER DISTRICT'S PROPOSED RATES

5/8-Inch Meter

| | | |
|-------|----------------|------------------------|
| First | 2,000 Gallons | \$ 18.14 Minimum Bill |
| Next | 3,000 Gallons | 7.53 per 1,000 Gallons |
| Next | 5,000 Gallons | 6.89 per 1,000 Gallons |
| Next | 10,000 Gallons | 6.24 per 1,000 Gallons |
| Over | 20,000 Gallons | 5.68 per 1,000 Gallons |

APPENDIX E
STAFF REPORT, CASE NO. 2011-00425
CASH FLOW ANALYSIS OF REVENUE REQUIREMENT

5/8-Inch Meter

| | | |
|-------|----------------|------------------------|
| First | 2,000 Gallons | \$ 18.59 Minimum Bill |
| Next | 3,000 Gallons | 7.71 per 1,000 Gallons |
| Next | 5,000 Gallons | 7.06 per 1,000 Gallons |
| Next | 10,000 Gallons | 6.40 per 1,000 Gallons |
| Over | 20,000 Gallons | 5.82 per 1,000 Gallons |

APPENDIX F
STAFF REPORT, CASE NO. 2011-00425
CASH FLOW ANALYSIS

| | |
|----------------------------------|-------------------------|
| Total Revenue | \$66,961 |
| Less: Operating Expenses | <u>50,273</u> |
| Net Operating Income | \$16,688 |
| Add: Depreciation & Amortization | <u>9,903</u> |
| Sub-total | \$ 26,591 |
| Less: Debt Service | <u>0</u> |
| Net Cash Flow | <u><u>\$ 26,591</u></u> |

Glen Goldsmith
Operator
Milburn Water District
7731 State Route 80 East
Arlington, KY 42021